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AGENDA ITEM 5a

TO: MEMBERS OF THE INVESTMENT POLICY SUBCOMMITTEE

- I. SUBJECT:** Revision of Policy on Global Proxy Voting, Consolidation of Global Principles of Accountable Corporate Governance and Core Principles of Accountable Corporate Governance, and Repeal of Existing Principles
- II. PROGRAM:** Global Equity
- III. RECOMMENDATION:** Recommend to the Investment Committee approval of: (1) Revised Statement of Investment Policy for Global Proxy Voting; (2) Consolidation of Global Principles of Accountable Corporate Governance and Core Principles of Accountable Corporate Governance; and (3) Repeal of Existing Principles.
- IV. ANALYSIS:**

Executive Summary

To support CalPERS' corporate governance principles based approach to voting proxies, influencing the capital marketplace, engaging companies, and implementing Corporate Governance Program initiatives to maximize Total Fund investment returns, staff is recommending:

- Revisions to CalPERS' Statement of Investment Policy on Global Proxy Voting (attachment 1).
- Revisions to CalPERS' Global Principles of Accountable Corporate Governance including three amendments to existing principles and the addition of eleven new principles. An amended version of the Global Principles is attached reflecting the recommended revisions (attachment 2).
- Consolidation of CalPERS' Global Principles of Accountable Corporate Governance and Core Principles of Accountable Corporate Governance into

one document entitled Global Principles of Accountable Corporate Governance. Attached to this cover memo are complete strikethrough copies of CalPERS' existing Core (attachment 3) and Global (attachment 4) Principles documents to reflect the repealing of existing principles documents which are being consolidated into the Global Principles of Accountable Corporate Governance.

Attachment 5 is a Wilshire Associates opinion letter supporting Staff's recommended revisions.

Background

CalPERS' Principles of Accountable Corporate Governance ("Principles") allow staff to efficiently and effectively implement its Corporate Governance Program responsibilities. Staff executes all proxy voting instructions, portfolio company engagement, and corporate governance initiatives in a manner that is consistent with the Investment Committee's ("Committee") Principles as described in CalPERS' Global Proxy Voting Policy ("Policy"). In 2007, the Committee approved revisions and a process by which staff must elevate the Principles to the Committee annually. For the first time in 2007, the Committee also approved the translation of CalPERS' Principles to Chinese, French, Japanese, German, Spanish and whatever additional language is necessary going forward to support the advocacy of the Principles on a global basis. All translated versions of the Principles are currently accessible through CalPERS' Shareowner Forum.

Statement of Investment Policy for Global Proxy Voting

Recommended revisions to the Statement of Investment Policy for Global Proxy Voting include policy template improvements and one technical amendment to define the Committee's corporate governance principles in a single document entitled Global Principles of Accountable Corporate Governance rather than the existing two document structure. This revision will improve the efficiency of working with the Committee's framework of principles without having to refer to multiple documents.

Global Principles of Accountable Corporate Governance

Recommended revisions include template formatting and language improvements to support the consolidation of the Committees existing Principles documents. Specific principles have not been deleted; rather, amendments to existing and new principles are being recommended. Table 1 summarizes three recommended amendments to existing principles that address CEO succession planning, executive equity ownership provisions, and sustainable long-term value creation in emerging markets. First, with regard to CEO succession planning, The New York Times reported in May of 2007 that "corporate boards were nearly three times as likely to pull the trigger on failing chief executives as they were a decade ago." CEO turnover can affect CalPERS' investments. For example,

CalPERS has a combined equity investment that exceeds \$1.2 billion in three companies where CEO turnover has recently been announced: Charles Prince's announced resignation from Citigroup, Richard Parsons' announced resignation from Time Warner, and Stanley O'Neal's announced retirement from Merrill Lynch. Staff's recommended amendment would strengthen CalPERS' existing principle to provide minimum characteristics of a CEO succession plan while ensuring that a company's board be held accountable for succession plan development, implementation, and review.

Second, Staff is recommending that CalPERS' executive compensation principle tied to equity ownership be strengthened to require equity attainment and continuous stock ownership. In 2006, compensation consultant Watson Wyatt reported that companies perform better when senior management and shareowner interests are aligned. Trends¹ over the last two years support adoption of executive stock ownership guidelines with 75.5% of Fortune 250 companies reporting the use of ownership guidelines in 2006, up from 70.2% in 2005. Third, staff is recommending that CalPERS' existing principle tied to sustainable long-term value creation in emerging markets be amended to provide clarity that company reporting guidelines specifically include activities being undertaken to protect shareowner rights and investment capital within the company's local emerging market.

Table 1
Principle Amendments

Market	Identifier	Topic	Principle Amendment
Domestic	B.2.9	CEO Succession Plan	The board of directors should proactively lead and be accountable for the development, implementation, and continual review of a CEO succession plan. Minimum characteristics to be encompassed in the CEO succession planning process are listed.
Domestic	B.3.3a	Executive Equity Ownership	Equity ownership should be required through the attainment and continuous ownership of a significant equity investment in the company. Executive stock ownership and holding requirements should be disclosed to shareowners on an annual basis.
Emerging	D.1	Sustainable Value Creation	Disclosure reporting guidelines include company activities being undertaken to protect shareowner rights and investment capital within its local emerging market.

Table 2 summarizes eleven recommended new principles that address audit integrity, board resources, director succession planning, director equity ownership, and the elimination of human rights violations in emerging markets. Seven audit integrity related principles are being recommended as CalPERS has a vested interest in maintaining the integrity and efficiency of the capital markets. Principle B.4.3 exemplifies CalPERS' belief that independence and objectivity of the external auditor is necessary to instill investors' confidence in the capital market. Therefore, companies should support the development of an accurate

¹ Source: Executive Compensation Trends: Equilar, October 2007

audited financial reporting framework. Critical to the integrity of the audited financial reporting framework is auditor independence in providing an opinion that financial statements are free from material misstatements.

The Sarbanes-Oxley Act of 2002 outlines the oversight role of the audit committee. Audit committees must understand the company's internal controls (Principle B.4.4) to determine whether these controls are adequate and operate effectively. The oversight (Principle B.4.5) of the financial reporting process is a critically important audit committee responsibility. To allow for sound investment decisions, investors must have the confidence that financial statements are accurate, provide proper transparency, and are consistent and comparable. Principle B.4.6 on audit committee expertise addresses the need for boards to evaluate and substantiate the needed skill-sets of the audit committee on an ongoing basis to ensure effective oversight.

Auditor independence may be impaired when the audit committee enters into an agreement of indemnity with the external auditor. Limiting the liability of the auditor might remove or weaken the auditor's objective and unbiased consideration of problems encountered in an engagement. Principle B.4.7 discourages companies from limiting the liability of its external auditor. Lastly, Principles B.4.8 and B.4.9 encourage audit committees to help improve market competition and reduce audit firm concentration by promoting a larger pool of auditors considered for the annual audit and promoting auditor rotation.

McKinsey & Company recently indicated² that public companies will need to raise their governance game if they are to compete with private companies by exerting ownership control over management through adequate incentives, resources, and voting power. Staff is recommending Principle B.1.11 to reference the need for a board of directors to have access to adequate resources. With adequate resources, corporate boards can commit the time and attention to understanding the business in order to hold management accountable.

Incentives and voting power can be achieved through equity ownership. The rationale for requiring executive management to attain and hold an equity investment should also apply to directors by encouraging active ownership in the companies they oversee. The addition of Principle B.3.7b, will improve the alignment of interest between directors and shareowners.

Succession planning is considered an important function to plan for CEO turnover. At the board level, turnover through retirement, resignation, or other means also exists. Provisions that mandate a required retirement age, reelection by shareowners, or renomination by boards, can all lead to director turnover. Principle B.2.10 would provide minimum characteristics of a director succession plan while ensuring that a company's board of directors is proactive in leading

² Source: What Public Companies can Learn from Private Equity; The McKinsey Quarterly (Web exclusive, January 2007)

and being held accountable for the development, implementation, and continual review of the director succession plan.

Finally, staff is recommending the addition of Principle D.2 that urges companies in emerging markets to adopt progressive practices toward the elimination of human rights violations. This new principle will reference adherence to the Global Sullivan Principles or the United Nations Global Compact principles in the area of human rights and labor standards as a recommended platform for addressing the elimination of human rights violations. The United Nations Global Compact is a framework for businesses that are committed to aligning their operations and strategies with principles in the areas of human rights, labor, the environment and anti-corruption.

Table 2
Recommended New Principles

Market	Identifier	Topic	New Principle
Domestic	B.1.11	Board Resources	The board should have access to adequate resources to provide independent counsel, advice, or other tools that allow the board to effectively perform its duties.
Domestic	B.2.10	Director Succession Plan	The board of directors should proactively lead and be accountable for the development, implementation, and continual review of a director succession plan. Minimum characteristics will be encompassed in the director succession planning process.
Domestic	B.3.7b	Director Equity Ownership	Director equity ownership should be required through attainment and continuous ownership of an equity investment in the company. Director stock ownership and holding requirements should be disclosed to shareowners on an annual basis.
Domestic	B.4.3	Auditor Independence	The audit committee should assess the independence of the external auditing firm on an annual basis. Minimum criteria should be disclosed in writing by the external auditor prior to acceptance of an auditing relationship.
Domestic	B.4.4	Assertion of Internal Financial Controls	The audit committee should require the auditor's opinion to include an opinion that includes commentary on any management assertion that the system of internal financial controls is operating effectively and efficiently, that assets are safeguarded, and that financial information is reliable as of a specific date, based on a specific framework of internal controls.
Domestic	B.4.5	Audit Committee Oversight	To ensure the integrity of audited financial statements, the corporation's interaction with the external auditor should be overseen by the audit committee.
Domestic	B.4.6	Audit Committee Expertise	Audit committee financial expertise at a minimum should include skill-sets as outlined by Section 229-407(d)(5)(i) of Regulation S-K and the Exchange listing requirements. Boards should consider the effectiveness of the audit committee and designated financial expert(s) in its annual assessment.
Domestic	B.4.7	Auditor Liability	To strengthen objective audit of financial reporting, audit committees should ensure that contracts with the auditor do not contain specific limits to the auditor's liability.

Domestic	B.4.8	Auditor Selection	Audit committees should promote expanding the pool of auditors considered for the annual audit to help improve market competition and thereby minimize the concentration of only a small number of audit firms.
Domestic	B.4.9	Auditor Rotation	Audit committees should promote auditor rotation every 5 – 7 years to ensure a fresh perspective and a review of the financial reporting framework.
Emerging	D.2	Eliminating Human Rights Violations	Adopt maximum practices toward elimination of human rights violations. Adherence to a formal set of principles, such as the Global Sullivan Principles, or the human rights and labor standards principles exemplified by the United Nations Global Compact, is recommended.

Upon adoption of staff's recommended revisions, staff will update CalPERS' Global Principles of Accountable Corporate Governance. The Principles will then be accessible through CalPERS' website, and will also be available in the form of professional glossy handouts. Staff will also update all translated versions.

V. STRATEGIC PLAN:

This item supports Goal VIII to manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize employer contributions.

VI. RESULTS/COSTS:

Costs associated with this item are expected to be minimal and can be absorbed within the Investment Office budget.

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